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IN THE

Supreme Court of the United States

OCTOBER TERM, 1943

INTERNATIONAL HARVESTER COMPANY,

Appellant,

vs.

WISCONSIN DEPARTMENT OF TAXATION,

Respondent.

ON APPEAL FROM THE SUPREME COURT FOR THE STATE OF WISCONSIN

BRIEF OF APPELLANT OPPOSING APPELLEE'S MOTION TO DISMISS APPEAL OR AFFIRM DECISION OF STATE COURT.

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MADISON, WISCONSIN

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Appellee having filed its "Statement Opposing Jurisdiction" of this Court, together with its motion to dismiss Appellant's appeal in the above entitled cause, or to affirm the decision of the Supreme Court of Wisconsin therein, Appellant, in pursuance of Rule 12, paragraph 3, and Rule 7, paragraph 3, of the Rules of the Supreme Court of the United States, files this brief opposing such motion.

I.

THE RECORD PRESENTS FOR DECISION SUBSTANTIAL FEDERAL QUESTIONS WHICH HAVE NOT BEEN RULED UPON BY THIS COURT.

In the preparation of Appellant's "Statement as to Jurisdiction" herein it was conceived that the nature of the case and the federal questions involved were such that it was appropriate to make a rather full analysis of the decision of the Wisconsin Supreme Court here directly involved and of other companion decisions of the Wisconsin Supreme Court in respect to the Wisconsin Privilege Dividend Tax Law. Since Appellee now in its "Statement Opposing Jurisdiction", simply quotes the decision of the State Supreme Court in the instant case we need here only emphasize the logic of that which already appears in Appellant's Statement as to Jurisdiction.

(a) The federal question in respect to the validity of the Wisconsin Privilege Dividend Tax Act as applied to foreign corporations and their non-resident stockholders.

There is here drawn in question the validity of the Wisconsin Privilege Dividend Tax Law. This Court has said that "For constitutional purposes the decisive issue turns on the operating incidence of a challenged tax." (*Wisconsin v. J. C. Penney Co.*, 311 U. S., 435, 444; 85 L. Ed., 267, 270) It is because the "operating incidence" of the Wisconsin privilege dividend tax has been finally and authoritatively determined by the Wisconsin court to be otherwise than conceived by this Court when it sustained that tax in *Wisconsin v. J. C. Penney Company, supra,* that the decision of this Court in that case is not here controlling.

That this Court sustained the Wisconsin Privilege Dividend Tax Law as imposing "an additional tax on corporate earnings

within Wisconsin" though postponing the liability for the tax until such earnings are paid out of dividends, cannot be questioned. The quoted language is taken from the majority opinion of this Court in *Wisconsin v. J. C. Penney Co.*, 311 U. S. 435, 442; 85 L. Ed., 267, 269. That was the effect of the majority opinion of this Court as recited by the minority in that case. The Wisconsin Supreme Court so read the decision of this Court. (*International Harvester Co. v. Wisconsin Department of Taxation*, 243 Wis. 198, 203, 10 N. W. 2d, 169, 171). The District Court of the United States for the Eastern District, and Tax Court of the United States, relied upon this interpretation. (*Wisconsin Gas & Electric Co. v. U. S.*, 46 Fed. Supp., 929, 930, (1942), and *Montreal Mining Co. v. Commissioner*, 2 Tax Court of U. S., No. 85 (Docket No. 106876, decided Sept. 16, 1943).

The Wisconsin Supreme Court, on the other hand, and subsequent to this Court's decision in the *Penney* case, has held in reference to the privilege dividend tax that the tax cannot be considered as an income tax on non-resident stockholders since as such it would be invalid under the Wisconsin Constitution, that "in no sense and to no extent whatever, is it a tax upon the income of the corporation" (*J. C. Penney Co. v. Tax Commission*, 238 Wis. 69, 73, 298 N. W. 186, 188); "held the law to be a privilege tax and not an income tax" (*International Harvester Co. v. Wisconsin Department of Taxation*, 243 Wis. 198; 205, 10 N. W. 2d 169, 171); and determined "(1) that the burden of the tax is specifically laid upon the stockholder; (2) that the corporation declaring the dividend must deduct the tax from the dividend and may not under any circumstances treat the tax as a necessary expense of doing business." (*Wisconsin Gas & Electric Co. v. Wisconsin Department of Taxation*, 243 Wis. 216, 220, 10 N. W. 2d, 140, 141).

A further development since the decision of this Court in the *Penney* case is in the formula used by the Wisconsin Department

of Taxation to determine the amount of the dividends attributable to Wisconsin. Mr. Justice Frankfurter noted in his opinion in the *Penney* case that "In the enforcement of this measure against foreign corporations the amount of income attributable to Wisconsin is calculated according to the same formula as that employed in assessing the general corporate income tax paid by such foreign corporations." (311 U. S. 441–442). But in the assessment involved in this appeal, as we shall show specifically under heading (c) of this brief, under the formula adopted by the Wisconsin Department of Taxation and approved by the Wisconsin Supreme Court, the amount of income attributed to Wisconsin is not calculated according to the income tax formula, but on a new and complicated formula utterly unknown to the Wisconsin income tax statute.

The very foundation for this Court's decision in the *Penney* case, sustaining the Wisconsin Privilege Dividend Tax Law, has thus been swept away, and the nature of the case is now such that there is presented the very important and substantial federal question whether the state may impose a tax upon non-resident stockholders of a foreign corporation for the privilege of receiving dividends declared by such foreign corporation,—the dividend being declared and received outside of Wisconsin and under the sanction of laws of sister states,—even though the income traceable to such dividend originated in Wisconsin and grew out of business which the corporation had been licensed by the state to transact.

It is contended by Appellee that there is no conflict between the decision of the Wisconsin Supreme Court here in question and the decision of this Court in *State of Wisconsin v. J. C. Penney Co.*, 311 U. S. 435, 85 L. Ed. 267. If that were so, why the diverse results in the lower federal courts in their attempt to construe and apply the Wisconsin privilege dividend tax act, depending upon whether they followed the decision of this Court

in the *Penney* case or followed the subsequent decisions of the Wisconsin Supreme Court in the instant case and in the companion cases decided on the same day? Why in the *Wisconsin Gas & Electric Co. v. United States* did the District Court for the Eastern District of Wisconsin, finding itself bound by this Court's determination in the *Penney* case that "the practical operation of the legislation is to impose an additional tax on corporate earnings within Wisconsin", hold that it was a tax against the corporation and by it deductible for federal income tax purposes; and why did the Circuit Court of Appeals, on appeal in that case, finding that the Wisconsin Supreme Court in the instant case and companion cases had "decided very clearly that the burden of this tax is upon the stockholder and not upon the corporation", reverse the District Court and hold that the Wisconsin privilege dividend tax was not an expense of the corporation, hence not deductible for federal income tax purposes? Why did the Circuit Court of Appeals in that case, on reversing the District Court whose decision had been controlled by this Court's construction of the law in the *Penney* case, say, "The reasoning of that case would seem to sustain the District Court's position." (*Wisconsin Gas & Electric Co. v. United States*, 46 Fed. Sup. 929 (1942); same case, 138 Fed. 2d 597 (November 8, 1943).) (Parenthetically it may be noted that in the case just cited petition for certiorari has been filed with this Court.)

If as asserted by Appellee there was no conflict, why did the United States Tax Court in the *Montreal Mining* case (2 Tax Court, No. 85), following the decision of this Court in the *Penney* case, hold, as did the federal District Court in the *Wisconsin Gas & Electric Co.* case, supra, that the Wisconsin privilege dividend tax was a deductible expense of the corporation?

It is true that the State Supreme Court tried earnestly to reconcile those differences, but only out of supposed compulsion and because it accepted the view that "the determination of the United

States Supreme Court settled all questions as to the jurisdiction of Wisconsin to levy the tax, whatever it be called." The Wisconsin court nevertheless in the same breath resolutely "(1) insisted upon its exclusive power to construe the law; and (2) held the law to be a privilege tax and not an income tax." (243 Wis. 198, 205; 10 N. W. 2d, 169, 171). In other words, the Wisconsin court boldly declared that "we adhere to our determination upon remand of the *Penney* case that this is a privilege tax and that we are bound to accept the mandate of the Supreme Court that its constitutional justification from the standpoint of Wisconsin power to tax is the fact of net earnings in Wisconsin treaceable to the fund distributed by the dividend (243 Wis. 206, 10 N. W. 2d, 172), and "(1) that the burden of the tax is specifically laid upon the stockholder; (2) that the corporation declaring the dividend must deduct the tax from the dividend and may not under any circumstances treat the tax as a necessary expense of doing business." (*Wisconsin Gas & Electric Co. v. Wisconsin Department of Taxation,* 243 Wis. 216, 220; 10 N. W. 2d, 140).

Notwithstanding such declarations the Wisconsin Supreme Court, confronting the contention "that the foreign stockholder of a foreign corporation has done no business in Wisconsin for which the tax may validly be levied," was forced to conclude:

> "This contention was foreclosed when the Supreme Court of the United States sustained the power of Wisconsin to levy this tax. It made its determination with the statute before it—a statute that plainly puts the burden of this tax upon the stockholder and not upon the corporation."
>
> *Wisconsin Gas & Electric Co. v. Wisconsin Department of Taxation,* 243 Wis. 216, 220.

It is, therefore, clear that it was only under the supposed compulsion of the decision of this Court sustaining the privilege dividend tax, albeit as an income tax against the corporation, that the Wisconsin Supreme Court reconciled its differences with this

Court and accepted the view that Wisconsin has jurisdiction to impose the tax in question.

Viewing the Act here challenged as imposing a tax on the privilege of declaring and receiving dividends against a foreign corporation and its non-resident stockholders, the Wisconsin Supreme Court had previously held in *J. C. Penney Co. v. Tax Comm.*, 233 Wis. 286, 289 N. W. 667:

> "the law was an unconstitutional attempt by Wisconsin to tax a privilege which it neither gave nor protected and that Wisconsin was consequently without jurisdiction to levy the tax." (So stated in 243 Wis. 198, 203)

As stated by the Wisconsin Supreme Court in its decision in the instant case this holding had been reached principally on the authority of *Connecticut General Life Ins. Co. v. Johnson*, 303 U. S. 77, where, as the Wisconsin court says:

> "Upon facts which appeared to us to be quite indistinguishable the Supreme Court of the United States had held California to be without jurisdiction to levy a privilege tax."

Nothing has been said by this Court, so far as we are aware, to shake the authority of the Connecticut General Life Insurance Company case. And now that the Wisconsin Supreme Court has authoritatively determined that the Wisconsin privilege dividend tax is "in no sense and to no extent whatever * * * a tax upon the income of the corporation", but on the contrary (answering the direct question, "On whom is the actual burden of this tax laid", and stating that "This question can have but one answer") has unequivocally declared, "The statute specifically puts it [the tax] upon the stockholder", and to be deducted from *his* dividend, there is presented an important, if not insurmountable, federal question whether the principle of *Connecticut General Life Ins. Co. v. Johnson*, 303 U. S. 77; 82 L. Ed. 673, does not compel this Court to strike down the Wisconsin privilege dividend tax

as applied to a foreign corporation and its non-resident stockholders. In that case Connecticut General Life Insurance Company did business in California under license from that state and entered into contracts with other insurance companies also licensed in California reinsuring them against loss on policies written by them in California on the lives of California residents. The contracts were made in Connecticut, premiums were paid there and the losses were there payable. California imposed a tax on the privilege of the company to do business within California, measuring that tax by gross premiums received. California officials attempted to collect the tax on premiums received by the Connecticut corporation under the reinsurance contracts in question, and the California Supreme Court sustained the tax. On appeal, this Court held that the tax was unconstitutional because it attempted to tax the privilege of doing acts which were not done in California. This Court declared that:

> "* * * there is no basis for saying that reinsurance which does not run to the original insured, and which, from its inception to its termination involves no action taken within California, even the settlement and adjustment of claims, is embraced in any privilege granted by that state." (303 U. S. 82; 82 L. Ed. 673, 678)

Distinguishing the *Connecticut General Life Insurance Company* case this Court, in the *Penney* case, supra, said that in the precise circumstances presented by the record in that case "it was found that the tax, neither in its measure, nor in its incidence, was related to the California transactions." Applying that distinguishing test to the Wisconsin privilege dividend tax as now finally construed by the Wisconsin Supreme Court it may likewise be observed that "the tax neither in its measure nor in its incidence" is related to Wisconsin transactions even though income included in the dividends is traceable to Wisconsin. As now authoritatively construed the tax is against the non-resident

stockholder, measured by and subtracted from his rights to receive payment of dividends declared and paid outside of Wisconsin and under the sanction of laws of sister states.

Application of the doctrine of *Provident Savings Life Assurance Society v. Kentucky*, 239 U. S. 103, 60 L. Ed. 167, will, we submit present the same federal question and ensuing result fatal to the Wisconsin law. Here there was involved a Kentucky privilege tax on a life insurance company which previously had carried on a life insurance business in the state, still continued its contracts on the lives of Kentucky residents, but had withdrawn from Kentucky and thereafter collected premiums on its Kentucky contracts at its home office in New York. This Court held that Kentucky could not lay a privilege tax against the Company, and at page 112, said:

> "Taxation without jurisdiction has been held to be a violation of the Fourteenth Amendment (*Louisville & J. F. Co. v. Kentucky*, 188 U. S. 385; *Delaware & W. R. Co. v. Penn.*, 198 U. S. 341; *Union Ref. Transit Co. v. Kentucky*, 199 U. S. 194); and the principle involved applies to the assertion of authority on the part of the state to exact a license tax for the privilege of doing acts which lie beyond the sphere of local control."

And continuing at pages 113 and 114 this Court said:

> "There is, however, a manifest difficulty in holding that the mere continuance of the obligation of the policies constituted the transaction of a local business for which a privilege tax could be exacted. As a privilege tax, the tax rests upon the assumption that what is done depends upon the state's consent. But the continuance of the contracts of insurance already written by the company was not dependent on the consent of the state. * * * These policies are contracts already made; the state cannot destroy them or make their mere continuance, independent of acts within its limits, a privilege to be granted or withheld. Neither the con-

tinuance of the obligation in itself, nor acts done elsewhere on account of it, can be regarded as being within the state's control."

There is a striking parallel between this Kentucky case and the case at bar. We have quoted the observation of this Court that the continuance of the contracts of insurance already written by the insurance company was not dependent upon the consent of the state, and for that reason Kentucky was held without power to impose the privilege tax there involved. After the income derived by this Appellant from its Wisconsin business had been realized, discharged of all burden of Wisconsin income taxes, and had become an indistinguishable part of Appellant's funds outside of Wisconsin, the disposition of those funds by appropriate corporate action taken outside of Wisconsin was as independent of the consent of Wisconsin as was the continuance of the life insurance contracts on the Kentucky lives. Indeed, the gap between the earning of the income in Wisconsin and the receipt of the dividend by the non-resident stockholder is even greater, since the privilege of earning is granted by the state to the corporation, whereas the privilege of receiving the dividend, which essentially is the privilege sought to be taxed, is enjoyed by one who may never have transacted business in the state.

The federal question thus presented by application of the unquestioned principles of the *Connecticut General Life Insurance Company* case and the *Provident Savings Life Assurance Society* case to the Wisconsin privilege dividend tax act as now construed by the Wisconsin Supreme Court cannot now be avoided by this Court's placing a construction on that act different from the construction now unequivocally declared by the Wisconsin Supreme Court.

This Court has declared, and all must recognize, that mere labels are not "instruments of adjudication." It has said that "for constitutional purposes the decisive issue turns upon the operat-

ing incidence of a challenged tax." The Wisconsin Supreme Court has now determined this pivotal question, and held the tax to be against the stockholder. This Court has declared that "Ascertainment of the scope of the exaction—what is included in it—is for the state court." (*Wisconsin v. J. C. Penney Co.*, 311 U. S. 435, 443, 85 L. Ed. 267.) The Wisconsin Supreme Court has exercised this prerogative and accepted the responsibility.

No doubt this Court may examine for itself and place its own construction on a state law, and in so doing may overrule the construction placed upon the law by the state court, in order to *strike down* the state statute *as an encroachment* upon rights guaranteed by the Federal Constitution. This Court's authority to correct judgments of state courts necessarily is inherent in the duty of this Court to prevent *encroachments* on the Federal Constitution or the *invasion* of rights guaranteed by the Federal Constitution. It is not, however, a function of this Court to review the judgments of state courts for the correction of errors *generally*.

Until this Court's decision in the *Penney* case there was, so far as we are aware, no precedent in which this Court under the due process clause had overruled the highest court of a state in respect to the construction of a state law for the purpose or with the result of *sustaining the state law*. The distinction is vital.

In *Phoenix Insurance Co. v. Gardiner*, 78 U. S. 204, 206; 20 L. Ed. 112, 114, the Court said:

> "* * * Now, we have repeatedly held that the construction of state statutes belongs to the state courts, and is not a Federal question which we can revise in a writ of error to a state court. It is true, if the state court gives such a construction to a state statute as to make it conflict with the Constitution or laws of the United States, and sustains its validity after giving it such construction, and thereby deprives a party of his rights under the said Constitution or laws, then a Federal question is raised, and we can review the decision on the point of the validity of the statute. * * *"

In *Erie R. R. Co. v. Tompkins,* 304 U. S. 64, 79; 82 L. Ed. 1188, 1194, the Court quoted with approval:

> "'* * * Supervision over either the legislative or the judicial action of the States is in no case permissible except as to matters by the Constitution specially authorized or delegated to the United States. Any interference with either, except as thus permitted, is an invasion of the authority of the State and, to that extent, a denial of its independence.'"

In *Rawlins v. Georgia,* 201 U. S. 638, 639; 50 L. Ed. 899, 900, it was said:

> "If the State Constitution and laws as construed by the state court are consistent with the Fourteenth Amendment we can go no further."

In short, while the United States Supreme Court determines for itself the constitutionality of the statute without being bound by the names or labels placed on the tax by the state legislature or the state supreme court, the state supreme court nevertheless is the final authority for determining the actual operation and incidence of the tax. The state supreme court, of course, cannot bind the United States Supreme Court by its *designation* of the nature of the tax nor by the *name* it gives to the tax, but clearly its determination of who pays the tax and of how the tax is collected, is final and binding upon the United States Supreme Court.

The fact unmistakably remains that the Wisconsin Supreme Court has said that the privilege dividend tax is not and cannot be considered an additional tax on corporate income. The Wisconsin Supreme Court has said that the tax cannot be deducted as a corporate expense by the corporation paying the dividend. The Wisconsin Supreme Court has said that under the Wisconsin Constitution an income tax cannot be levied on a non-resident stockholder. The Wisconsin Supreme Court has said that the tax must be withheld from the dividend paid to a non-resident stockholder.

We submit that this Court now takes the tax for its consideration in view of all these developments since its decision in the *Penney* case, and that it must now determine, in view of the decisions of the Wisconsin Supreme Court in respect not merely to the name or label of the tax but as to the actual operation and effect of the law, whether the tax denies federal due process of law.

In the face of the foregoing principles and in the light of the construction unequivocally placed upon the law by the Wisconsin Supreme Court, any action by this Court in placing a different construction upon the state law would constitute the assumption of a prerogative which is inconsistent with our constitutional system of government.

(b) The federal question in respect to the validity of the Privilege Dividend Tax Act as applied to dividends from income accumulated prior to enactment of the law.

The second federal question presented by Appellant's Statement as to Jurisdiction, involving validity of the Privilege Dividend Tax Law as applied to dividends from income accumulated prior to enactment of the law, has not heretofore been submitted to or passed upon by this Court. It assumes that the law is otherwise valid, though obviously in presenting this federal question Appellant does not concede such validity.

Is it possible, within the principles of due process under the Federal Constitution, to sustain the Act in question as imposing a tax upon dividends declared and paid subsequent to the enactment of the law, but from income accumulated by the corporation over an indefinitely long period prior to the enactment? Basically the answer to this question depends upon the determination as to the nature of the tax, whether grounded upon the privilege granted by the state to the corporation of carrying on business in the state, or whether based solely upon the privilege of declaring

and receiving dividends. It is not enough to look at the simple transaction of declaring and receiving dividends; if the law is to be sustained at all as against foreign corporations and their non-resident stockholders it will be on some broader basis than this simple transaction; it is necessary, therefore, to look to whatever foundation has been shoved under the tax structure to support its constitutionality, however unstable and anomalous that may be. The only ground thus far suggested to sustain the tax against foreign corporations and their non-resident stockholders is the privilege granted by the state to the corporation to transact business and derive income in the state; that, it has been said (although before the Wisconsin court had finally determined the tax to be a privilege tax against the stockholder in contrast to an income against the corporation) is the privilege to which the tax bears the requisite fiscal relationship. (*Wisconsin v. J. C. Penney Co.*, 311 U. S. 435, 85 L. Ed. 267)

Looking, therefore, to the question of permissible retroactivity of the tax and assuming for the argument that the law is otherwise valid, we find the justification for the tax stated by the Wisconsin Supreme Court thus:

> "We adhere to our determination upon remand of the *Penney Case* that this is a privilege tax and that we are bound to accept the mandate of the United States supreme court that its constitutional justification from the standpoint of Wisconsin's power to tax is the fact of net earnings in Wisconsin traceable to the fund distributed by the dividend." (243 Wis. 198, 206; 10 N. W. 2d, 169, 172)

Though feeling itself compelled to accept the mandate of this Court, the Wisconsin court nevertheless in its decision in the instant case pointed out that this Court had reduced the privilege of declaring and receiving dividends "to mere conditions or contingencies, on the happening of which the tax accrues." In considering the retroactive effect of the tax law regard must be had

to the "jurisdictional fact" or "basis of Wisconsin's power to tax" rather than to the "mere conditions or contingencies upon which the tax may accrue", the more so since such "mere conditions or contingencies", being the declaration and receipt of the dividends, occurred entirely outside the state.

If the state's power to tax the non-resident stockholder of a foreign corporation is to be justified by the privilege granted by the state to that corporation to earn income within the state, then under the decisions of this Court as to the permissible retroactivity of new tax laws the thrust of the tax cannot reach income earned by the corporation prior to the date of enactment of the law. In *Welch v. Henry*, 305 U. S. 134; 83 L. Ed. 87, this Court affirmed the Wisconsin court in sustaining application of the Wisconsin income tax retroactively to "recent transactions", i.e., dividends received in a prior year. Against the objection that the tax because retroactive was a denial of due process, this Court, at page 147, said:

> "In the cases in which this Court has held invalid the taxation of gifts made and completely vested before the enactment of the taxing statute, decision was rested on the ground that the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event. * * * Since, in each of these cases, the donor might freely have chosen to give or not to give, the taxation, after the choice was made, of a gift which he might well have refrained from making had he anticipated the tax, was thought to be so arbitrary and oppressive as to be a denial of due process."

Upon the issue of permissible retroactivity of the tax the Wisconsin court, in the instant case, was evenly divided, and the tax assessment against Appellant was accordingly affirmed. On behalf of the three Justices who would limit the retroactive operation of the law it was said:

"(1) that since the United States Supreme Court has held that the label placed upon this law by the legislature or by this court is wholly ineffective to impair its constitutionality as against the contention that Wisconsin is without power to levy the tax, such label or designation or the selection by Wisconsin of the payment and receipt of the dividend as the occasion for the tax, is equally ineffective to save it from objections to its retroactivity; (2) that the earnings of the corporation in Wisconsin upon which are grounded Wisconsin's power to levy the dividend tax must be within reach of a retroactive tax; (3) that the extent of permissible retroactivity should be determined upon the analogy of the income tax cases; (4) that retroactivity should only be permitted to 'recent' transactions; (5) that consistently with these principles the tax may not be applied to earnings in Wisconsin which accrued prior to the last corporate fiscal year preceding the enactment of Wisconsin privilege dividend tax; (6) that by reason of the severability clause, the operation of the tax should be so limited; (7) that nothing in the decision upon remand requires a different conclusion." (P. 208)

Even the retroactivity which would have been permitted by the members of the Wisconsin court, whose views are quoted above, would be condemned as arbitrary and lacking due process under the tests laid down by this Court. Thus, for the Wisconsin privilege dividend tax there was no precedent in Wisconsin law, nor so far as we are aware, in the laws of any other state. At no time prior to the initiation of the particular legislative process could that tax have been anticipated. Prior to 1935, while Appellant was exercising the privilege of doing business in Wisconsin and accumulating the surplus from which the dividends in question were later paid there was no intimation of a tax to be imposed *generally* upon residents and non-residents alike upon the *distribution* of Wisconsin income. There was indeed overwhelming precedent in the decisions of the Wisconsin Supreme Court that such a tax could not constitutionally be imposed. (*Newport Co.*

v. Tax Comm., 219 Wis. 293; *State ex rel. Manitowoc Gas Co. v. Tax Comm.*, 161 Wis. 111; *Stone v. Tax Comm.*, 197 Wis. 71)

Mr. Justice Roberts, in the *Penney* case, filed a dissenting opinion in which Mr. Chief Justice Hughes, Mr. Justice McReynolds and Mr. Justice Reed concurred. It was there said:

> "I assume also that, where a state has, by law, fixed the conditions upon which a corporate citizen of another state may enter to transact business, she may not thereafter extend her sovereignty to matters not within her competence, in the guise of annexing other and further conditions or burdens upon the transaction of the corporation's business within her borders." (P. 446–447)

For the privilege of doing business, granted by Wisconsin to Appellant for the years prior to enactment of the dividend tax, Appellant had met all conditions exacted by the state. The privilege had ripened into vested rights, since the income derived from Wisconsin business, completely discharged from all income taxes, or other charges or restrictions, had been reduced to capital, had been sent outside of Wisconsin, and had become an indistinguishable part of Appellant's funds held beyond the borders of Wisconsin. Such fruits of the privilege granted by Wisconsin were protected from further legislative encroachment. Appropriate to this situation is the following language quoted by this Court in *Coolidge v. Long*, 282 U. S. 582, 603; 75 L. Ed. 562, 570, taken from *Re Craig*, 97 Appellate Division, 289, affirmed 181 N. Y. 551:

> "But when the privilege has ripened into a right it is too late to impose conditions of the character in question, and when the right is conferred by a lawfully executed grant or contract it is property and not privilege, and as such is protected from legislative encroachment by constitutional guaranties."

It is asserted by Appellee that the tax in question is no more retroactive than a tax on capital gains in the year of sale where the asset was acquired years prior thereto. The argument fails since neither federal nor state law attempts to impose a tax on gains accrued prior to the enactment of the income tax law. In both jurisdictions, federal and state, the income tax on capital gains realized subsequent to enactment of the law applies only to such part of the gain as accrues after the enactment. Under the Wisconsin Privilege Dividend Tax law, as here assessed, the tax is applied to surplus accumulated before the date of enactment. Again it is asserted by Appellee that the tax in question is no more retroactive than an income tax imposed upon a stockholder on corporate dividends received by him. This argument illustrates the vice of looking at the tax as a simple transaction tax on the declaring and receiving the dividend rather than on the exercise by the corporation of the privilege of earning in Wisconsin the income from which the dividend is paid, which is the supposed justification for the tax conceived by this Court and reluctantly accepted by the Wisconsin Supreme Court.

(c) The federal question involved in the application of a formula for determining the basis of the tax which is not authorized by the statute.

The third issue also has not heretofore been presented to this Court. It is, briefly, whether the assessment made by the Wisconsin Department of Taxation on a formula not provided for by the Wisconsin Privilege Dividend Tax Act is a denial of due process of law under the Fourteenth Amendment to the Federal Constitution.

The Wisconsin Privilege Dividend Tax Act provides that the proportion of the dividend allocated to Wisconsin shall be ascertained "in accordance with the provisions of Chapter 71." Chap-

ter 71 is the Income Tax Chapter. The Privilege Dividend Tax Act adds that in the absence of proof to the contrary the dividends "shall be presumed to have been paid out of earnings of such corporation attributable to Wisconsin under the provisions of Chapter 71 during the year immediately preceding the payment of such dividends."

Chapter 71 provides that in the case of a corporation doing business within and without Wisconsin there shall first be deducted non-apportionable income and that the remaining or apportionable income shall be allocated to Wisconsin on the average of three ratios: The ratio of tangible property in Wisconsin to total tangible property, the ratio of sales in Wisconsin to total sales, and the ratio of cost of manufacturing in Wisconsin to total cost of manufacturing.

It is provided that if the use of any one ratio gives an unreasonable or inequitable final average ratio that ratio may be omitted.

This average ratio is, under the income tax computation, applied to the apportionable net income.

In the privilege dividend tax assessment involved in this appeal the above income tax fraction has been applied by the Wisconsin Department of Taxation to ascertain the portion of the *book* income each year derived from Wisconsin. That is all it is used for. It is dropped out of the computation from that point on. The Wisconsin Department of Taxation proceeded to accumulate such *book* income derived from Wisconsin from year to year. It called the accumulated amount Wisconsin income reflected in surplus.

When a dividend was paid it divided Wisconsin income reflected in surplus by total surplus and multiplied the total dividend paid by this fraction. The result obtained was the amount of the dividend attributed to Wisconsin which was taxed at the regular rate.

It will be seen how far distant this process is from ascertainin the amount of the dividend derived from Wisconsin under th provisions of Chapter 71, the Income Tax Chapter.

In the first place the income tax formula is used only to dete mine the proportion of *book* income in the current year derive from Wisconsin.

In the income tax calculation the income tax fraction is applie against taxable net income, not book net income.

Taxable net income is a very different figure from book ne income. For one thing, reserves are deducted in arriving at boo net income, but not in arriving at taxable net income.

Wisconsin earnings reflected in surplus is neither an income ta figure nor a book figure. It is a figure resulting wholly from computation made by the Wisconsin Department. It is utterl unknown to Chapter 71, the Income Tax Chapter; it is utterl unknown to the Wisconsin Privilege Dividend Tax Act.

Total surplus is a book figure which is not used in the incom tax computation.

Wisconsin earnings reflected in surplus divided by total sur plus is a fraction utterly unknown to the Income Tax Chapter an to the Wisconsin Privilege Dividend Tax Act.

For detailed computation of tax see Exhibit 7a, Rec. 138–14

It is significant, we submit, that the Wisconsin Privilege Divi dend Tax Act provides that if a corporation had a loss for th year prior to the payment of the dividend the Department of Taxa tion "shall upon application" determine the portion of the divi dend "paid out of corporate surplus and undivided profits derived from business transacted and property located within the state." (Wis. Stats. Ch. 71.61(4)). Obviously the application referred to is that of a taxpayer. But there is no such provision for determining the portion of the dividend paid out of surplus

except in the case of a loss and then only in the case of an application by the taxpayer. In the case of a corporation which did not have a loss the ascertainment must be made according to Chapter 71, the Income Tax Chapter. The record shows in this case that there was no loss by the Appellant in any of the years involved. (Exhibit 7A, Rec. 149)

There is no alternative formula provided for in the Income Tax Chapter. The only modification of the income tax formula that may be made is, as we have seen, that one of the three ratios may be dropped out. But there is no provision for substituting a new ratio in place of the one dropped out, much less for substituting an entirely new formula.

Neither is there an alternative formula provided for in the Wisconsin Privilege Dividend Tax statute.

It is obvious that the formula adopted by the Wisconsin Department of Taxation is wholly unknown to the income tax statute and is wholly unknown to the Wisconsin Privilege Dividend Tax statute.

We submit, therefore, that the Wisconsin Department of Taxation has ascertained the amount of the dividends taxed in this case by a process wholly unauthorized either by the Wisconsin privilege dividend tax act or the Wisconsin income tax law.

In the case of *Davis v. Wallace*, 257 U. S. 478, 66 L. Ed. 325, 329, the United States Supreme Court said that where the formula provided for by the statute could not be constitutionally applied the taxing officers were not "at liberty to assess it on another and different basis which the statute shows was not to be applied to corporations in a class to which these railroad companies belong." It added, "Of course we cannot so hold."

Likewise, in *Oklahoma v. Wells Fargo Company*, 223 U. S. 298, 56 L. Ed. 445, a case in which the statutory formula could not constitutionally be applied, Mr. Justice Holmes, writing the opinion, declared that "Neither the court below nor this Court

can reshape the statute simply because it embraces elements that it might have reached had it been drawn with a different measure and intent."

In *Commonwealth v. P. Lorillard Co.*, 105 S. E. 683, 685, the Supreme Court of Appeals of Virginia cited with approval the case of *Oklahoma v. Wells Fargo Co., supra*, and stated that the taxing power:

> "is exerted through the legislature, and an executive officer who seeks to enforce a tax must always be able to put his finger upon the statute which confers such authority. Taxes can only be assessed, levied and collected in the manner prescribed by express statutory authority. Tax assessors have no power to make an assessment except in the manner prescribed by law, and if the statute prescribes a method of assessment which is invalid, the assessor has no power or authority to adopt a method of his own which would have been legal if it had been prescribed by the legislature."

It went on to say "The statute conferred no such authority on them [the taxing officers] and they had no such power", namely, no power to "devise a scheme of their own by which to determine how much of the total income of the defendant in error was derived from business done in this state." It held that "the Legislature alone could exercise this power, and, having failed to do so, no such apportionment can be made. * * *"

In *Dravo Contracting Company v. James*, 114 Fed. (2d), 242, (C. C. A. Fourth Cir.), there was involved a West Virginia gross income tax applying in that case to a contractor constructing locks and dams in West Virginia under a contract with the Federal Government. The court said that it agreed with the taxpayer

> "that the court was without power to apportion its [the taxpayer's] income on the basis of the cost of the activities involved in earning the income within and without the state. No such basis of apportionment is prescribed by statute; and, in the absence of statute, the court is without power to

adopt it, as this is a legislative function involved in the imposition of the tax, and therefore not one which courts may exercise."

This Court denied certiorari in this case. (312 U. S. 678; rehearing denied 312 U. S. 714).

See also:

Fisher v. Standard Oil Co., 12 Fed. 2d, 744, 747.
Ford Motor Co. v. State, 258 N. W. 596, 603. (N. Dak.)

Appellee, in its Statement Opposing Jurisdiction, argues that the formula adopted by the Wisconsin Department of Taxation was approved by the Wisconsin Supreme Court in its opinion in this case and that, therefore, the formula is not now merely a formula of the Wisconsin Department of Taxation, but a formula approved by the Wisconsin Supreme Court.

But the Wisconsin Supreme Court has no more power to evolve a formula not authorized by the statute than the Wisconsin Department of Taxation has. (*Oklahoma v. Wells Fargo Co.*, also *Dravo Contracting Co. v. James*, quoted above)

This Court has emphatically held that a formula which allocates an arbitrary or excessive portion of capital stock value or of net income to the taxing state is a denial of due process of law. This was held as to a state income tax in *Hans Rees' Sons v. N. Carolina*, 283 U. S. 123, 75 L. Ed. 879.

As a formula allocating an excessive amount of income or of capital stock value is a denial of due process of law, a fortiori a formula allocating an amount of dividend derived from Wisconsin under a formula wholly unauthorized by law is a denial of due process. The very essence of due process is taxation according to constituted authority granted by statute and a tax levied on a basis devised by taxing officers without any authority by statute whatever would seem necessarily to be a denial of due process of law.

We submit, therefore, that the use of an unauthorized formula for determining the amount of the dividend attributable to Wisconsin is a denial of due process of law under the Fourteenth Amendment, and the record in this respect presents a substantial federal question.

Dated this 12th day of January, 1944.

Respectfully submitted,

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